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DOCKET NO. RPU-91-5



ERRY E. BRANSTAD, GOVERNOR

IOWA UTILITIES BOARD
DEPARTMENT OF COMMERCE

MIDWEST GAS, A DIVISION OF
IOWA PUBLIC SERVICE COMPANY

Docket No. RPU-91-5

"FINAL DECISION AND ORDER"

Issued May 15, 1992

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The undersigned hereby certifies that
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to each such party a copy thereof, in
properly addressed envelope with charges
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Date: 05-15-92.....

Walter Ladd.....

STATE OF IOWA
DEPARTMENT OF COMMERCE
UTILITIES BOARD

IN RE:

MIDWEST GAS, A DIVISION OF IOWA
PUBLIC SERVICE COMPANY

DOCKET NO. RPU-91-5

FINAL DECISION AND ORDER

(Issued May 15, 1992)

SYNOPSIS¹

On July 15, 1991, Midwest Gas, a division of Iowa Public Service Company, filed a request to increase its gas rates. The Utilities Board (Board) authorized an increase of approximately \$6.1 million. The Board allowed a rate of return on common equity of 12.25 percent. The rate base allowed was \$207.2 million and the revenue requirement allowed was \$281.7 million.

The above amounts are calculated on a total Midwest Gas division basis and will be allocated to the various state jurisdictions, resulting in a lesser amount for the Iowa jurisdiction.

Several adjustments to the test year were part of a settlement agreement approved by the Board on February 27, 1992.

Adjustments to 1990 test year revenues and expenses over and above the adjustments approved in the settlement included, but were not limited to, costs associated with former manufactured gas clean-up, 1992 salary increase, an adjusted acquisition adjustment, holding company merger costs and related of merger savings, and a management efficiency reward.

¹The purpose of this synopsis is to provide readers a brief summary of the decision. While the synopsis reflects the order, it shall not be considered to limit, define, amend, or otherwise affect in any manner the body of the order including the findings of fact and conclusions of law.

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precedent and will maintain its "stand-alone" policy. A major determinant in this decision is the state legislation which was enacted in 1989. In IOWA CODE § 476.71 (1991), the legislature mandated that utility and affiliate operations remain financially separate. That section states in part:

It is the intent of the general assembly that a public utility should not directly or indirectly include in rates or charges any costs or expenses of an affiliate engaged in any business other than that of utility business unless the affiliate provides goods or services to the public utility. The costs that are included should be reasonably necessary and appropriate for utility business.

The legislation clearly is intended to prevent cross-subsidization. While ratepayers should not subsidize nonutility services, the affiliate companies should also not be required to subsidize utility operations. The costs and expenses incurred which produced the tax losses of the affiliate companies were borne by the stockholders rather than ratepayers. If the Board allowed the benefits of those losses to go to the ratepayers, stockholders would be forced to subsidize the utility cost of service. The decision whether to cross the line between utility service and affiliate companies should not be determined by whether it is beneficial to ratepayers. For these reasons, the Board concludes it is appropriate to continue to recognize Midwest Gas's "stand-alone" method of accounting for income taxes.

V. COST OF EQUITY

The U.S. Supreme Court, in its decision in Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591, (1944), held:

The rate-making process under the Act, i.e., the fixing of "just and reasonable" rates, involves a balancing of the investor and the consumer interests. Thus we stated in the Natural Gas Pipeline Co. Case that "regulation does not insure that the business shall produce net revenues." But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and the dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain credit and attract capital.

Id. at 603 (citations omitted). Various models have been developed to estimate the return necessary to attract equity capital. In Duquesne Light Company and Pennsylvania Power Company v. David M. Barasch 488 U.S. 299, 109 S.Ct. 609 (1989), the Supreme Court noted no one method was imposed on public utility commissions in reaching their conclusions. This Board has relied upon the discounted cash flow (DCF) model, with secondary emphasis on the risk premium model. See Iowa Southern, "Final Decision and Order," Docket No. RPU-89-7 (September 14, 1990), pp. 28-33; Iowa-American Water Company, "Final Decision and Order," Docket No. RPU-90-10 (October 21, 1991). The principles stated in those orders will be relied on by the Board for guidance in this case regarding the cost of equity. However, the Board will make its decision based on the specific facts and arguments presented in this case.

The only component of the rate of return in dispute was the return on common equity. Midwest Gas calculated a 14.0 percent cost of equity, using

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two methods for measuring cost of equity: 1) discounted cash flow (DCF) and 2) risk premium. In his DCF method, Midwest Gas witness Vander Weide used a quarterly DCF model, with a five percent reduction to price as an adjustment for flotation costs. His main DCF results were:

- a. 13.7 percent for Midwest Resources;
- b. 14.2 percent for his Value Line gas distribution group; and
- c. 14.3 percent for his Standard & Poor's gas distribution group.

In the risk premium analysis, witness Vander Weide used a risk premium of 4.5 to 5.5 percentage points. (Tr. 60). Adding this to the most recent Moody's A-rated bond rate of 8.84 percent produced a cost of equity under the risk premium approach from 13.34 percent to 14.34 percent. (Ex. 38).

Consumer Advocate proposed an 11.3 percent cost of common equity. The proposal was based upon a DCF analysis of Midwest Resources and supported by company specific "risk premium" analyses of other Iowa-based utilities or utility holding companies. (Tr. 257-83, 289-301; Ex. 101, Sch. A-J; Ex. 102, Sch. A-C; Ex. 103, Sch. A-E). Consumer Advocate witness Habr asserted that if a continuous DCF model is applied to witness Vander Weide's combination utility proxy group (Ex. 1, Sch. 5-7), a median cost of equity of 11.5 percent results.

Consumer Advocate also calculated the cost of equity for a group of witness Vander Weide's gas distribution companies using the continuous DCF model instead of Midwest Gas's quarterly model. The result was 13.3 percent for the group using Midwest Gas witness Vander Weide's May 1991 IBES forecasts for growth. When updated with Zacks' February 1992 forecasts, the average cost of equity was 12.76 percent. An average of

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12.28 percent resulted if companies with significant non-gas revenue were dropped from the group. (Ex. 120).

Mid-Size proposed a 10.89 percent return on common equity, using the Federal Energy Regulatory Commission (FERC) DCF model in analyzing four sets of natural gas distribution companies. Mid-Size witness Dahlen's analyses did not include Midwest Resources and the estimates ranged from 10.35 percent to 10.89 percent. (Tr. 1708-10, 1714-17, 1732-36; Ex. 206, Sch. 2-4).

Midwest Gas is an operating division of Iowa Public Service Company, which is a wholly owned subsidiary of Midwest Resources. Only Midwest Resources' stock is publicly traded. Therefore, for its main analysis, the Board will analyze Midwest Resources. The Board will also look at the DCF analysis of proxy groups of utility companies as an initial check on the DCF analysis. In the past the Board has found reason to look at combination electric/natural gas groups as a proxy in checking the cost of equity for a combination company such as Iowa Public Service. That approach was premised on the theory that a comparable investment for an investor would be in another combination utility or its parent. However, Midwest Gas witness Vander Weide has made a persuasive showing in this case that it is also appropriate to look at groups of natural gas companies as a check on Midwest Gas since those companies have comparable risks. Midwest Gas is a natural gas company and has different risks than combination electric/natural gas companies. (Tr. 55-56). Finally, the Board will look at the results from risk premium analyses as another check on the DCF analysis.

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A. DCF ANALYSIS

While the Board has previously found the FERC model a useful compromise between the continuously compounded DCF model and annually discrete models, the testimony of Midwest Gas's witness Vander Weide has persuaded the Board that the annually discrete model also has merit. The Board takes note that FERC has discontinued its annual generic cost of equity determination based upon the FERC DCF model. The Board will look at the results of both the FERC and the annually discrete DCF models. The annually discrete model is as follows:

$$K = [D_0(1 + G)/P] + G, \text{ where}$$

K = the cost of equity capital to be determined

D_0 = current indicated dividend

P = stock market price

G = growth rate

The Board will not use Midwest Gas's quarterly DCF model. Both Consumer Advocate and Mid-Size appear to be correct in asserting that Midwest Gas's quarterly DCF model provides for double recovery of interest on dividends already paid.

1. Dividend

Midwest Resource's most recent quarterly dividend contained in the record is \$0.39 paid on a quarterly basis, or \$1.56 on an annual basis. (Tr. 261, Ex. 1, Sch. 4). The Board will use the figure \$1.56 in its analysis.

2. Price

Midwest Gas used a simple average of the high and low stock prices for the three-month period ending May 31, 1991. The source used by Midwest Gas is Standard and Poor's Stock Guide. The price is \$19.583 for Midwest Resources. (Tr. 52; Ex. 1, Sch. 4). Consumer Advocate used an average daily closing price for the period November 7, 1990, through June 28, 1991. The price is \$19.13 for Midwest Resources, and Consumer Advocate updated that price for December 20, 1991, through February 12, 1992, to \$20.125. The Board will use the most recent average of \$20.125 provided by Consumer Advocate.

3. Growth Rate

Midwest Gas used the May 1991 consensus analysts' estimates of future earnings per share (EPS) growth reported by Institutional Brokers' Estimate System (IBES), which is 4.83 percent for Midwest Resources. Midwest Gas provided the January 1992 IBES update of 4.47 percent. (Ex. 39). Consumer Advocate advocated a growth rate of 3.1 percent, the midpoint of the 2.9 percent to 3.3 percent range it estimated. The 2.9 percent is an estimate of internal growth for Midwest Resources using a representative retention ratio. The 3.3 percent is based on Midwest Resources dividend growth rate for the nine-year period ending in 1990. (Tr. 261-69; Ex. 101, Sch. C). Mid-Size used the July 5th 1991 Value Line estimate for dividend growth for each of the gas distribution companies used. (Tr. 1709; Sch. 2-5).

The Board will continue to look at both historical growth estimates and forecasted growth estimates. The historical growth rate used by the Board is 2.51 percent for Midwest Resources. This is the average of 3.485

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percent, the ten-year least squares growth estimate of dividends per share, and 1.544 percent, the average of ten years internal growth. (Ex. 101, Sch. 3, p. 1). However, in general, the Board believes forecasted growth rates are better predictors of future growth than historical growth rates. In his testimony at transcript page 50, Midwest Gas witness Vander Weide supported his use of the IBES growth forecasts stating:

The IBES consensus growth rates (1) are widely circulated in the financial community, (2) include the projections of reputable financial analysts who develop estimates of future EPS growth, (3) are reported on a timely basis to investors, and (4) are widely used by institutional and other investors. For these reasons, I believe these consensus estimates are unbiased estimates of the investors' expectation of each firm's long-term dividend growth prospects and, accordingly, are incorporated by investors into their return requirements. Consequently, in my opinion, they provide a sound estimate of investors' long-term dividend growth expectations.

The Board is persuaded they are the better gauge of investors' expectations of growth. (Tr. 51). In this case, that is particularly true given the necessity of hypothesizing the historical growth rates of two companies since merged.

Midwest Gas also supported its position by citing a study, James Vander Weide and Willard Carleton's "Investor Growth Expectations and Stock Prices: the Analysts versus Historical Growth Extrapolation," The Journal of Portfolio Management, Spring, 1988. That study showed regression results containing the consensus analysts' forecasts exceeded the regression results containing the historical growth estimates. According to witness Vander Weide, this is consistent with the hypothesis that

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investors use analysts' forecasts, rather than historically oriented growth calculations in making buy and sell decisions. (Tr. 51).

The Board will rely primarily on the January 1992 IBES update of 4.47 percent provided by Midwest Gas in its analysis. (Ex. 39).

4. Flotation Costs

Midwest Gas used a five percent downward adjustment to the DCF price as an allowance for flotation costs, thereby increasing the DCF cost of equity estimated and adding 0.46 percent to his cost of equity estimate for Midwest Resources. (Tr. 215). Midwest Gas contended a flotation adjustment was appropriate even if common stock was not issued in the test year and believes the adjustment should apply to all common equity, including retained earnings.

Consumer Advocate argued if Midwest Gas's flotation cost adjustment of 46 basis points were applied to Midwest Resources' consolidated net utility assets of about \$1.5 billion, then Midwest Resources would perpetually receive flotation costs of \$4,865,000 annually before taxes. The latest Midwest Resources common stock issue had a one-time cost of less than \$2 million. (Tr. 231, 234). According to Consumer Advocate, if a flotation cost adjustment is going to be made, then a secondary market transaction cost adjustment also needs to be made.

The Board has held that a flotation adjustment may be warranted in some cases. For example, in Peoples Natural Gas Company, Docket No. RPU-86-11 (March 30, 1987), the Board accepted a flotation adjustment advocated by Consumer Advocate. An adjustment seemed especially germane when there was a recent or planned issuance of common equity, as evidenced in this

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case. However, as witness Vander Weide pointed out, there are issuance costs associated with all issues of common stock whether issued recently or sometime ago. The issuance costs of all debt issues are recovered over the life of those issues. Unlike debt, however, stock has a perpetual life making it inappropriate to recover these costs through amortization over a definite period. Therefore, recognition should be given to the need for a carrying charge to be applied to the issuance costs.

Midwest Gas is correct in arguing that the primary disagreement between Midwest Gas and the Consumer Advocate regards the size of, rather than the need for, a flotation adjustment. The proposed adjustments range from zero to five percent. The five percent adjustment to price used by Midwest Gas is too much and does not take into account a needed secondary market transaction cost adjustment. As noted above, it is reasonable to reflect some flotation costs. The Board believes that as an alternative, it is reasonable to make a two percent flotation adjustment. If a two percent adjustment is made, the result is an adjusted DCF price of \$19.72, and if no adjustment for flotation is made the price is \$20.29.

5. DCF Results

Utilizing this data produces the following results for Midwest Resources:

	No flotation		2.0 % flotation	
	D/P	K	Adj. D/P	K
Annually Discrete DCF				
-Historical growth	7.95	10.46	8.11	10.62
-Forecasted growth	8.10	12.57	8.26	12.73
FERC DCF				
-Historical growth	7.85	10.36	8.01	10.52
-Forecasted growth	7.93	12.40	8.09	12.56

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Midwest Gas also provided analysis for a combination electric/natural gas proxy group using the FERC DCF model. (Ex. 1, Schs. 5-6). The results were 10.5 percent using historical growth estimates and 12.2 percent using forecasted growth estimates. (Ex. 1, Schs. 5-6). Based upon an annually discrete DCF model, these figures are, respectively, 10.57 and 12.35 percent. With a two percent flotation adjustment, the FERC model results, respectively, become 10.62 percent and 12.34 percent. The annually discrete DCF results become 10.73 and 12.51 percent.

Mid-Size provided analysis of gas distribution proxy groups using the FERC DCF model and Value Line forecasted dividend growth. The results were 10.35 to 10.89 percent.

B. RISK PREMIUM ANALYSIS

The Risk Premium model is based on the premise that common equity carries a higher risk than debt and, for this reason, investors require a higher expected return. According to this theory, some estimate of expected risk premium is added to the current market determined debt yield to produce an estimate of the current equity return requirement. Controversy exists on the exact form of the model and the debt rate to use, and especially on the estimate of the risk premium. The capital asset pricing model (CAPM) is a variant of the risk premium approach.

Midwest Gas provided testimony that the short run risk premium may rise as interest rates fall. (Tr. 218-20). The Board understands the rationale behind this argument, and, in light of the current low interest rates, will give more weight to the upper part of the 2.5 to 3.5 percentage risk premium range it has heretofore employed.

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The risk premium method used by Midwest Gas is similar to the method used by the Board. See, Iowa Electric Light and Power Company, Docket No. RPU-89-9 (October 25, 1990); Iowa-American Water Company, Docket No. RPU-90-10 (October 21, 1991). The difference is in the magnitude of the risk premium itself. Using the updated 8.84 percent estimate for the yield on debt, plus adding a risk premium range of 250 to 350 basis points, supports a cost of equity estimate of about 11.34 to 12.34 percent. (Ex. 38).

As another check, the Board reviewed the recent return on equity decisions of other public utility commissions for natural gas distribution utilities. (Ex. 63). The 1991 average return on equity was 12.48 percent and the 1992 average to date is 12.92 percent. The overall average was 12.51 percent for 1991 and 1992. (Ex. 63). The Board notes that it is important that decisions of other commissions not be relied upon exclusively because of the potential circular effect. However, these facts are useful as a secondary check on the Board's decision. The Supreme Court said in Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1944), "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks." While the return averages should not be used as the sole means of determining the return on common equity for Midwest Gas, a review of the returns of other gas distribution utilities is useful as a check of whether Midwest Gas's return is commensurate with the returns of other gas utilities.

C. RETURN ON EQUITY

The DCF analyses of Midwest Resources supports a cost of equity range of 10.4 to 12.7 percent. Our preference for the forecasted growth estimates

suggests the upper end of this range. DCF analysis of the combination proxy group supports a cost of equity range of 10.5 to 12.5 percent. Midwest Gas witness Vander Weide's DCF analysis of gas distribution groups provided results of 14.2 to 14.3 percent. These, however, reflected an excessive adjustment for flotation and that his particular quarterly DCF model overestimates the cost of equity. The Board's risk premium analysis suggests a range of 11.34 to 12.34 percent. While the DCF analysis remains the Board's primary approach, testimony in this proceeding raises significant doubts about its continued reliability.

Therefore, based on the various methods discussed in this order, the range is somewhere between 12.7 percent on the high side and 10.4 percent on the low side. Taking all of these methods into consideration and taking into consideration the particular facts of this case, the Board believes the proper cost of equity for Midwest Gas to be in the upper range of the DCF analysis and the risk premium check. The Board finds 12.25 percent as a reasonable determination of the cost of equity. The DCF analyses, with or without the flotation adjustment, and the risk premium analysis all support 12.25 percent.

VI. CLASS COST OF SERVICE

A. ALLOCATION OF ACCOUNT 920 FOR "SUPPLY ALLOWANCE" EXPENSE

Midwest Gas proposed to allocate the "supply allowance" portion of administrative and general salaries, Account 920, using a throughput allocator. (Tr. 587). According to Midwest Gas, this method distributes a one cent per MCF cost reflective of the role gas distribution systems play in acquiring gas supplies, securing and coordinating transportation,

DIRECT TESTIMONY
OF
DR. JAMES H. VANDER WEIDE

ON BEHALF OF

MIDWEST GAS,
A DIVISION OF IOWA PUBLIC SERVICE COMPANY

BEFORE THE
IOWA UTILITIES BOARD

DOCKET NO. RPU-91-5

1 measures in predicting a firm's stock price.

2 Q. WHAT PRICE DID YOU USE IN YOUR DCF MODEL?

3 A. I used a simple average of the high and low stock prices for each
4 firm for the three-month period ending March 1991. These high and
5 low stock prices were obtained from the Standard & Poor's Stock
6 Guide, a source generally available to and used by investors.

7 Q. WHY DID YOU USE THE THREE-MONTH AVERAGE STOCK PRICE
8 IN APPLYING THE DCF METHOD?

9 A. I used the three-month average stock price in applying the DCF
10 Method because stock prices fluctuate daily, while financial
11 analysts' forecasts for a given company are generally changed less
12 frequently, often on a quarterly basis. Thus, to match the stock
13 price with an earnings forecast, it is appropriate to average stock
14 prices over a three-month period.

15 Q. DID YOU INCLUDE AN ALLOWANCE FOR FLOTATION COSTS IN
16 YOUR DCF ANALYSIS?

17 A. Yes. I have included a 5 percent allowance for flotation costs in my
18 DCF calculations.

19 Q. PLEASE EXPLAIN YOUR INCLUSION OF FLOTATION COSTS.

20 A. All firms which have sold securities in the capital markets have
21 incurred some level of flotation costs, including underwriters'
22 commissions, legal fees, printing expense, etc. (For a complete
23 description of flotation costs and a review of literature relating to
24 flotation costs, see Vander Weide Appendix 2.) These costs are
25 withheld from the proceeds of the stock sale or are paid separately,
26 and must be recovered over the life of the equity issue. Costs vary
27 depending upon the size of the issue, the type of registration
28 method used and other factors, but in general these costs range

1 between 3 and 5 percent of the proceeds from the issue [see
2 Clifford W. Smith, "Alternative Methods for Raising Capital,
3 Journal of Financial Economics 5 (1977) 273--307]. In addition to
4 these costs, for large equity issues (in relation to outstanding
5 equity shares), there is likely to be a decline in price associated
6 with the sale of shares to the public. On average, the decline due
7 to market pressure has been estimated at 2 to 3 percent [see
8 Richard H. Pettway, "The Effects of New Equity Sales Upon Utility
9 Share Prices," Public Utilities Fortnightly, May 10, 1984, 35--39].

10 From the above evidence, the total flotation cost, including both
11 issuance expense and market pressure, could range anywhere from
12 5 to 8 percent of the proceeds of an equity issue. I believe a
13 combined 5 percent allowance for flotation costs is a conservative
14 estimate that can be used in applying the DCF Model in this
15 proceeding and, therefore, I have used a 5 percent flotation
16 allowance.

17 Q. WHY SHOULD MIDWEST GAS BE ALLOWED TO RECOVER
18 FLOTATION EXPENSES IF NO ISSUANCE OF COMMON STOCK
19 OCCURRED DURING THE TEST YEAR?

20 A. A flotation cost adjustment is required whether or not a company
21 issued new stock during the test year. Previously incurred
22 flotation costs have not been expensed in previous rate cases;
23 rather, they are a permanent cost associated with past issues of
24 common stock. Just as an adjustment is made to the embedded cost
25 of debt to reflect previously incurred debt issuance costs,
26 regardless of whether additional bond issuances were made in the
27 test year, so should an adjustment be made to the cost of equity
28 regardless of whether additional stock was issued during the test

1 year.

2 Q. DOES AN ALLOWANCE FOR RECOVERY OF FLOTATION COSTS
3 ASSOCIATED WITH STOCK SALES IN PRIOR YEARS CONSTITUTE
4 RETROACTIVE RATE-MAKING?

5 A. No. My adjustment for flotation costs on equity is not meant to
6 recover any cost that is properly assigned to prior years. In fact,
7 my adjustment allows Midwest Gas only to recover current carrying
8 costs associated with flotation expenses incurred at the time stock
9 sales were made. The original flotation costs themselves will never
10 be recovered, because the stock is assumed to have an infinite life.
11 In my opinion, the flotation cost adjustment would be retroactive
12 ratemaking only if it allowed the company to recover at this time the
13 annual carrying costs of prior years.

14 Q. PLEASE SUMMARIZE THE RESULTS OF YOUR APPLICATION OF
15 THE DCF METHOD TO YOUR TWO COMPARABLE GROUPS OF
16 NATURAL GAS DISTRIBUTION COMPANIES.

17 A. The DCF results for my two groups of comparable natural gas
18 distribution companies are shown on Schedules 2 and 3 of my
19 exhibit. The average DCF cost of equity for the Value Line group
20 of natural gas distribution companies is 14.2 percent. The average
21 DCF cost of equity for the Standard & Poor's natural gas
22 distribution companies is 14.3 percent. On the basis of these
23 results, I conclude that the DCF cost of equity for Midwest Gas is in
24 the range 14.0 to 14.5 percent.

25 Q. WHAT RESULTS DID YOU OBTAIN FROM YOUR APPLICATION OF
26 THE DCF METHOD TO MIDWEST RESOURCES?

27 A. As shown on Schedule 4, the DCF estimate for Midwest Resources is
28 13.7 percent.

DOCKET NO. RPU-94-3

STATE OF IOWA
DEPARTMENT OF COMMERCE
UTILITIES BOARD

IN RE:

MIDWEST GAS, A DIVISION OF
MIDWEST POWER SYSTEMS INC.

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) DOCKET NO. RPU-94-3
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FINAL DECISION AND ORDER

(Issued May 19, 1995)

SYNOPSIS¹

On July 21, 1994, Midwest Gas, a division of Midwest Power Systems Inc., filed a request for a general rate increase in temporary and final gas rates. On October 14, 1994, the Board set temporary rates, granting Midwest Gas a temporary revenue increase of approximately \$8.2 million on an Iowa Jurisdictional basis.

In its final decision the Board approved a partial settlement which set the revenue increase at \$12,050,000, set new depreciation rates, and approved the implementation of a pilot project called the Incentive Gas Supply Procurement Program.

¹The purpose of this synopsis is to provide readers a brief summary of the decision. While the synopsis reflects the order, it shall not be considered to limit, define, amend, or otherwise affect in any manner the body of the order including the findings of fact and conclusions of law.

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APPEARANCES

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SUSAN PRAZEN, Attorney, Peoples Natural Gas Company, Division of UtiliCorp United Inc., 1815 Capitol Avenue, Omaha, Nebraska 68102; and PHILIP E. STOFFREGEN, Attorney, Dickinson, Mackaman, Tyler & Hagen, P.C., 1600 Hub Tower, 699 Walnut Street, Des Moines, Iowa 50309, appearing on behalf of Peoples Natural Gas Company.

GP 15077

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I. PROCEDURAL HISTORY

On July 21, 1994, Midwest Gas filed tariffs identified as TF-94-382 and TF-94-383. In TF-94-382, Midwest Gas proposed a temporary increase which would produce additional Iowa jurisdictional revenue of approximately \$9,848,910. In TF-94-383, Midwest Gas proposed a permanent annual Iowa jurisdictional revenue increase of approximately \$16,006,545, or 6.32 percent over current rates. On August 19, 1994, the Board issued an order suspending the tariffs and instituting an investigation to determine the reasonableness of the tariffs. Intervention was granted to the Iowa Energy Consumers (IEC), Deere & Company (Deere), and Peoples Natural Gas Company, Division of UtiliCorp United Inc. On October 14, 1994, the Board issued an "Order Setting Temporary Rates." On February 17, 1995, Midwest Gas, the Consumer Advocate Division of the Department of Justice (Consumer Advocate), IEC, and Deere filed a proposed partial settlement and a joint motion requesting the Board approve the settlement. An addendum to the partial settlement was filed on March 9, 1995. Peoples did not object to the proposed settlement. The parties filed testimony, and on February 22 through February 24, the Board held hearings for the cross-examination of testimony relating to the unresolved issues. On March 14, 1995, the Board held a hearing for the cross-examination of additional testimony and to ask questions regarding the proposed settlement. The parties filed briefs.

II. TEST YEAR

The test year for the proceeding is 1993.

III. SETTLEMENT

The Board has reviewed the partial settlement filed by Midwest Gas, Consumer Advocate, IEC, and Deere on February 17, 1995, and finds it to be reasonable in light of the whole record, consistent with law, and in the public interest. The partial settlement will be approved, and the parties' joint motion for an order approving the settlement is granted pursuant to IOWA ADMIN. CODE 199-7.2(11) (1995).

In the proposed settlement, the parties agreed to a total revenue increase, not including depreciation changes, of \$12,050,000. However, the parties did not provide the Board with a precise agreement as to specific issues. Instead, the parties provided two different revenue requirements and two different rates of return, establishing a range. The Board will set a "hypothetical" reference point for the rate of return and the return on common equity. It is useful for the Board to have an historical benchmark return on equity to compare to Midwest Gas's ongoing performance. However, it would be inconsistent with the settlement to set a formal rate of return and, therefore, this benchmark will be used only for the Board's informal monitoring of Midwest Gas's performance and, if necessary, as a reference point in Midwest Gas's next energy efficiency cost recovery proceeding. The parties agreed to a range of 9.454 to 9.777 percent for the rate of return and a range of 11.6 percent to 12.3 percent for the return on common equity. The benchmark rate of return and the benchmark return on common equity will be set precisely midway between the ranges, or 9.6155 percent and 11.95 percent, respectively. For compliance tariffs, the parties must design rates that produce a revenue requirement that does not exceed the highest revenue requirement in the settlement nor fall below

Docket No. RPU-94-3
Page 6

the lowest revenue requirement shown in the settlement, modified for depreciation changes as ordered by the Board in this decision. The parties agreed to refile their schedules to the settlement once the outstanding depreciation issues are decided by the Board. (Tr. 59-60). The Board will require the parties to file the amended schedules 15 days from the date of this order.

The settlement also encompasses agreement on some specific cost-of-service study and rate design issues. In general, the Board applauds aspects of this portion of the settlement which express a forward-looking policy. Specifically, the parties' agreement on the gas retention and the balancing tolerance issues illustrate the policy of giving the customer some flexibility coupled with more responsibility. The Board finds this customer empowerment effort to be important in this era of change in the gas industry.

In addition, the Board will discuss its understanding and ask for some additional information with respect to some of the specific issues that were included in the proposed settlement. First, regarding the resolution of the Optional Negotiated Pricing Provision and the Pipeline Corridor Tariff, the parties did not specify how revenues would be treated. At the hearing, the parties agreed Midwest Gas would annualize revenues at the full tariffed level for purposes of rate design, but would continue to share any revenue excesses or deficiencies at the time of the annual reconciliation. (Tr. 24-25, 73). The Board finds this agreement to be a reasonable resolution.

Second, the parties agreed the monthly customer charge for the Optional Negotiated Pricing Provision and the Pipeline Corridor Tariff will

Docket No. RPU-94-3

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be \$400. Midwest Gas retained the right to agree to a lesser customer charge provided that it determined based on a cost/benefit analysis that a discount is justified. Midwest Gas should provide the Board and Consumer Advocate with the analysis performed to determine that a discount is justified. At the hearing, the parties agreed that any shortfall created by the discount would be shared with customers on a 50 percent basis through the annual purchased gas adjustment (PGA) reconciliation. (Tr. 30, 73). The Board also finds this to be reasonable.

IV. CONTESTED ISSUES

A. RATE DESIGN ISSUES

1. CRITICAL DAY NEGATIVE IMBALANCE CHARGE

Midwest Gas proposed to increase its Critical Day Negative Imbalance charge from \$10 to \$30 per MMBtu. According to Midwest Gas, this increase is necessary to protect the integrity of the system during critical periods and to reflect the charges imposed on Midwest Gas by interstate pipelines. Additional revenues earned through collection of the imbalance charges will be credited to sales customers through the PGA reconciliation.

IEC challenged the proposal, stating the charge is not designed as a cost-based rate. According to IEC, the imposition of a charge which is up to three times the cost of penalties charged to Midwest Gas violates the Board's rule, IOWA ADMIN. CODE 199-19.13(4), which requires all rates and charges for transportation to be based on the cost of providing service.

The Board has reviewed the arguments of the parties and determined the balancing charge is reasonable. The charge is assessed when a transporter uses more gas than it nominates, thus affecting system supply. Midwest Gas

STATE OF IOWA
DEPARTMENT OF COMMERCE
BEFORE THE IOWA UTILITIES BOARD

IN RE:

MIDWEST GAS A Division of
MIDWEST POWER SYSTEMS INC.

DOCKET NO.

RPV-94-3

DIRECT TESTIMONY
OF
DR. JAMES H. VANDER WEIDE

I. INTRODUCTION

1 Q. Please state your name and business address.

2 A. My name is James H. Vander Weide. I am Research Professor of Finance
3 and Economics at the Fuqua School of Business of Duke University. I am
4 also President of Financial Strategy Associates, a firm that provides strategic
5 and financial consulting services to clients in the electric, gas, insurance,
6 telecommunications, and water industries. My business address is 3606
7 Stoneybrook Drive, Durham, North Carolina.

8 Q. Would you please describe your educational background and prior
9 academic experience?

10 A. I graduated from Cornell University in 1966 with a Bachelor's Degree in
11 Economics. I then attended Northwestern University where I earned a Ph.D.
12 in Finance. In January 1972, I joined the faculty of the School of Business
13 at Duke University and was subsequently named Assistant Professor,
14 Associate Professor, and then Professor.

15 Since joining the faculty I have taught courses in corporate finance,
16 investment management, and management of financial institutions. I have
17 also taught a graduate seminar on the theory of public utility pricing and

1 Q. Please explain your inclusion of flotation costs.

2 A. All firms which have sold securities in the capital markets have incurred some
3 level of flotation costs, including underwriters' commissions, legal fees,
4 printing expense, etc. (For a complete description of flotation costs and a
5 review of the literature relating to flotation costs, see Vander Weide Appendix
6 2.) These costs are withheld from the proceeds of the stock sale or are paid
7 separately, and must be recovered over the life of the equity issue. Costs
8 vary depending upon the size of the issue, the type of registration method
9 used and other factors, but in general these costs range between 3 and 5
10 percent of the proceeds from the issue [see Clifford W. Smith, "Alternative
11 Methods for Raising Capital," *Journal of Financial Economics* 5 (1977) 273--
12 307]. In addition to these costs, for large equity issues (in relation to
13 outstanding equity shares), there is likely to be a decline in price associated
14 with the sale of shares to the public. On average, the decline due to market
15 pressure has been estimated at 2 to 3 percent [see Richard H. Pettway, "The
16 Effects of New Equity Sales Upon Utility Share Prices," *Public Utilities*
17 *Fortnightly*, May 10, 1984, 35--39].

18 From the above evidence, the total flotation cost, including both issuance
19 expense and market pressure, could range anywhere from five to eight
20 percent of the proceeds of an equity issue. I believe a combined five percent
21 allowance for flotation costs is a conservative estimate that can be used in
22 applying the DCF Model in this proceeding and, therefore, I have used a five
23 percent flotation allowance.

1 Q. Why should Midwest Gas be allowed to recover flotation expenses if no
2 issuance of common stock occurred during the test year?

3 A. A flotation cost adjustment is required whether or not a company issued new
4 stock during the test year. Previously incurred flotation costs have not been
5 expensed in previous rate cases; rather, they are a permanent cost
6 associated with past issues of common stock. Just as an adjustment is made
7 to the embedded cost of debt to reflect previously incurred debt issuance
8 costs, regardless of whether additional bond issuances were made in the test
9 year, so should an adjustment be made to the cost of equity regardless of
10 whether additional stock was issued during the test year.

11 Q. Does an allowance for recovery of flotation costs associated with stock
12 sales in prior years constitute retroactive rate-making?

13 A. No. My adjustment for flotation costs on equity is not meant to recover any
14 cost that is properly assigned to prior years. In fact, my adjustment allows
15 Midwest Gas only to recover current carrying costs associated with flotation
16 expenses incurred at the time stock sales were made. The original flotation
17 costs themselves will never be recovered, because the stock is assumed to
18 have an infinite life. In my opinion, the flotation cost adjustment would be
19 retroactive rate-making only if it allowed the company to recover at this time
20 the annual carrying costs of prior years.

21 Q. Please summarize the results of your application of the DCF method to
22 the *Value Line* group of natural gas distribution companies.

23 A. The DCF results for the *Value Line* group of natural gas distribution
24 companies are shown on Schedule 1 of my exhibit. The average DCF cost
25 of equity for this group of natural gas distribution companies is 12.1 percent.

REBUTTAL TESTIMONY
OF
DR. JAMES H. VANDER WEIDE

ON BEHALF OF

Midwest Gas

BEFORE THE
IOWA UTILITIES BOARD

DOCKET NO. RPU-94-3

1 component that is significantly lower than the market risk premium
2 recommended by Ibbotson Associates, his primary data source.

3 Dr. Habr's use of unrealistically low interest rates, low common stock
4 betas, and a low market risk premium cause him to understate the cost of
5 equity capital for Midwest Gas.

6 8. Test of Reasonableness. Dr. Habr's recommended 9.74 percent
7 rate of return on equity for Midwest Gas is only 74 to 121 basis points
8 higher than recent yields on Moody's A-rated utility bonds. The risk
9 premium implied by Dr. Habr's 9.74 percent recommendation is significantly
10 lower than the risk premiums the Iowa Utilities Board has applied in recent
11 decisions. The Iowa Board, for example, in setting interim rates in this
12 docket, applied a 350 basis point risk premium to the 8.47 percent July yield
13 on A-rated utility bonds, obtaining a cost of equity of 12.0 percent.

14 9. Flotation Costs. Dr. Habr's arguments on flotation costs are based
15 on an inappropriate economic model of the effect of flotation costs on firm
16 value. If Dr. Habr had used more appropriate models found in the literature,
17 he would have found that flotation costs have a significant influence on a
18 firm's cost of equity.

19 10. Risk Premium. Dr. Habr argues that my application of the Risk
20 Premium Method is invalid because the Iowa utilities are less risky than the
21 S&P Utility Group and the S&P 500. Dr. Habr's analysis, however, is based
22 on "beta" calculations for the Iowa utilities that are significantly less than
23 the beta values found in *Value Line*, the most widely-respected source of
24 betas. Furthermore, Dr. Habr fails to recognize that utility investments are
25 significantly more risky today than they were over the life of my study.

used the correct model of how flotation costs affect the value of the firm, he would have concluded that the flotation cost adjustment is both legitimate and material.

Risk Premium

Q. What are Dr. Habr's major criticisms of your risk premium method of estimating the cost of equity capital for Midwest Gas?

A. Dr. Habr has three criticisms of my risk premium analysis. First, he argues that it is incorrect to use risk premiums based on the S&P 500 and the studies described in my Appendix 3 because these risk premiums relate to companies that are more risky than Midwest Gas. Second, he argues that it is also inappropriate to base a risk premium for Midwest Gas on data for the S&P Utilities because these companies are also more risky than Midwest Gas. Finally, he argues that my risk premium studies are invalid because they are based on a four percent coupon rate for bonds.

Q. Do you agree with Dr. Habr's criticisms of your risk premium approach?

A. No. Dr. Habr's assessment of the risk of the S&P 500 and the S&P Utilities relative to the risk of Midwest Gas is faulty. First, Dr. Habr's reported betas for the Iowa utilities are significantly less than *Value Line's* reported betas for these same utilities. Investors are more likely to rely on *Value Line* betas to assess risk than on Dr. Habr's betas.

Second, Dr. Habr fails to recognize that my risk premiums relate to the S&P Utilities and the S&P 500 over the last 54 years. Given the recent increased competition in the electric utility industry, Midwest Gas is more risky today than the average S&P utility over the last 54 years.

A. Yes. As noted in my direct testimony, flotation costs are a legitimate expense of providing utility service. Investors will not have a legitimate opportunity to earn their required rate of return on equity if flotation costs are not recovered in the regulatory process. A correct formulation of how flotation costs should be included in the cost of equity is provided in an article by Brigham, Aberwald, and Gapenski titled, "Common Equity Flotation Costs in Rate Making," *Public Utilities Fortnightly*, May 1985. (See Habr Schedule I, page 10 of 10.)

Q. What is Dr. Habr's view concerning the inclusion of flotation costs in a firm's cost of equity capital?

A. Dr. Habr agrees that flotation costs are a legitimate expense of providing utility service. He claims, however, that a proper analysis of the flotation cost adjustment should include the effect of brokerage fees investors pay in the secondary market. When brokerage fees in the secondary market are considered, Dr. Habr argues that the magnitude of the flotation cost adjustment is minimal. Dr. Habr's views on flotation costs are expressed in an article attached as Schedule I of his rebuttal testimony.

Q. Do you agree with Dr. Habr's argument?

A. No. Dr. Habr's analysis of the flotation cost issue is based on an incorrect model of how flotation costs affect the value of the firm. In particular, Dr. Habr relies on a model developed by Arzac and Marcus (see Habr Direct Testimony, Schedule I, p. 4 of 10). Dr. Habr should have relied on the model appearing in articles by Patterson; Howe; and Brigham, Aberwald, and Gapenski (see references Habr Schedule I, p. 10 of 10). If Dr. Habr had

- Q. What is the risk premium implied by Dr. Habr's recommended 9.74 percent rate of return on equity for Midwest Gas?
- A. Dr. Habr's recommended 9.74 percent rate of return on equity for Midwest Gas is only 121 basis points higher than the 8.53 percent average yield on Moody's A-rated utility bonds in the two months ending September 30, 1994, and only 74 basis points higher than the yield on Moody's A-rated utility bonds in November. His recommendation, therefore, implies a risk premium in the range 74 to 121 basis points.
- Q. What risk premium range has the Iowa Utilities Board found to be appropriate in recent decisions?
- A. In its Final Decision and Order in Docket No. 93-6, the Iowa Utilities Board widened its traditional risk premium range from 250 to 350 basis points to a range of 250 to 450 basis points. The upper end of this range is supported by the risk premium studies reported in my direct testimony.
- Q. What cost of equity is implied by a risk premium range of 250 to 450 basis points?
- A. Adding the 9.0 percent yield on A-rated utility bonds in November 1994 to a risk premium range of 250 to 450 basis points implies a cost of equity of 11.5 percent to 13.5 percent, which is 175 to 375 basis points higher than Dr. Habr's recommended cost of equity.

Flotation Costs

- Q. Should an allowance for flotation costs be included in an estimate of a firm's cost of equity capital?

The I/B/E/S growth estimates provide a better estimate of investors' expectations of future growth than Mr. Ahn's growth rates.

Flotation Allowance

Q. Does Mr. Ahn include an allowance for the recovery of flotation expenses in his cost of equity recommendation for Midwest Gas?

A. No. On page 20 of his testimony, Mr. Ahn states that since "Midwest incurred no flotation costs during the test year; Midwest should recover no flotation costs."

Q. Do you agree with Mr. Ahn's reason for excluding flotation expenses?

A. No. As noted on page 33 of my direct testimony, the current flotation cost adjustment is not meant to recover flotation costs incurred during the test year. As I state there,

A flotation cost adjustment is required whether or not a company issued new stock during the test year. Previously incurred flotation costs have not been expensed in previous rate cases; rather, they are a permanent cost associated with past issues of common stock. Just as an adjustment is made to the embedded cost of debt to reflect previously incurred debt issuance costs, regardless of whether additional bond issuances were made in the test year, so should an adjustment be made to the cost of equity regardless of whether additional stock was issued during the test year.

Risk Premium

Q. What are Mr. Ahn's basic criticisms of your risk premium method of calculating the cost of equity for Midwest Gas?

A. Mr. Ahn has four criticisms of my risk premium method of calculating the cost of equity for Midwest Gas. First, Mr. Ahn contends on page 20 of his testimony that I have used "outdated historical data for nine disparate risk premium studies." Second, Mr. Ahn claims that my risk premium analysis

DOCKET NO. 81-0747

1 IOWA-ILLINOIS GAS AND ELECTRIC COMPANY
2 Illinois Commerce Commission - Docket No. 81-0747
3 Direct Testimony of Charles A. Benore

- 4 Q. Please state your name and business address.
- 5 A. Charles A. Benore, Paine Webber Mitchell Hutchins Inc., 140
6 Broadway, New York, New York 10005.
- 7 Q. By whom are you employed and in what capacity?
- 8 A. I am a specialist in the analysis of utility securities and a
9 First Vice President and member of the Board of Directors of
10 Paine Webber Mitchell Hutchins Inc., a subsidiary of Paine
11 Webber, Inc. Paine Webber Mitchell Hutchins provides
12 investment research services to institutional and individual
13 investors. Our clients include most medium and large-sized
14 financial institutions in the United States and many abroad
15 as well, and individual investors through Paine, Webber,
16 Jackson & Curtis, which is another subsidiary of Paine
17 Webber, Inc.
- 18 Q. Are you familiar with the investment concerns of security
19 investors?
- 20 A. Yes. Paine Webber Mitchell Hutchins is in daily touch with
21 hundreds of portfolio managers, traders and security analysts
22 from banks, corporations, insurance companies, mutual funds,
23 and other financial institutions, and individual investors.
24 This activity gives us a very current view of buyers and
25 sellers of securities.

1 fundamentals. For these principal reasons, a comparison with
2 only electric companies is unsound.

3 Moreover, my testimony demonstrates that the financial
4 assets of individuals and institutions are not restricted to
5 electric utility common stock investments. Instead, bonds
6 and common stocks are included in such financial assets, and
7 the preponderance of common stock investments is in
8 industrial companies. Therefore, to determine if Iowa-
9 Illinois can compete in the marketplace for capital, it is
10 unsound to compare with only electric companies, which
11 account for 3% of the market value of common stocks, and to
12 ignore the other 97% of common stock alternatives available
13 to investors. Furthermore, my testimony demonstrates that
14 risk in electric companies is at least equal to industrial
15 companies on four different measures. Since risk is
16 comparable, returns should also be.

17 Q. What is Iowa-Illinois' cost of common equity capital
18 according to your second test?

19 A. The second test indicates a cost of common equity of 17-1/2%,
20 and conservatively adjusted for market pressure and issuance
21 costs of 5%, Iowa-Illinois' cost of common stock is 18.4%
22 (17.5% divided by 1.00 - .05).

23 Q. In your DCF test, what should Iowa-Illinois' growth component
24 be?

1 elements of financial integrity and to induce investors to
2 invest capital in Iowa-Illinois rather than in an alternative
3 investment opportunity.

4 Q. What is the importance of adequate financial strength and
5 financial flexibility?

6 A. Adequate financial strength and flexibility are necessary to
7 maintain bond ratings, to cope with possible problems of
8 capital inadequacy in the future, and to finance on an
9 advantageous basis.

10 Q. Why should Iowa-Illinois' level of financial integrity be no
11 higher than necessary to maintain rates that are fair?

12 A. Equity. The price of electric service to the Company's
13 customers should be fair, as should the return to the
14 investor.

15 Q. What is Iowa-Illinois' cost of common equity capital?

16 A. The cost of Iowa-Illinois' common stock equity is at least
17 18% as indicated by the following tests:

18		Iowa-Illinois Cost
19	<u>Test</u>	<u>of Common Equity Capital</u>
20	Risk Premium	18.2%
21	Discounted Cash Flow	18.4%
22	Financial Integrity	18.0%

23 Q. You are aware, are you not, that the Company is proposing the
24 inclusion of some \$21 million of construction work in
25 progress in the electric rate case?

IOWA-ILLINOIS GAS AND ELECTRIC COMPANY

Illinois Commerce Commission - Docket No. 81-0747

Rebuttal Testimony of Charles A. Benore

- 1 Q. Please state your name and business address.
- 2 A. Charles A. Benore, Paine Webber Mitchell Hutchins Inc., 140
3 Broadway, New York, New York 10005.
- 4 Q. Are you the same Charles A. Benore that testified as to Iowa-
5 Illinois' common stock capital cost in this proceeding?
- 6 A. Yes.
- 7 Q. What is the purpose of your rebuttal testimony?
- 8 A. The purpose of my testimony is to rebut the cost of capital
9 testimony of Mr. Thomas M. Zepp and the testimony of Mr.
10 Kevin P. O'Meara as it may effect cost of capital.
- 11 Q. What will your testimony show?
- 12 A. My testimony will show that Mr. Zepp's cost of common stock
13 equity testimony for Iowa-Illinois is internally
14 inconsistent, contains several fundamental contradictions,
15 and that his CAPM and DCF methodologies indicate a materially
16 higher cost of common stock for Iowa-Illinois than he has
17 estimated.
- 18 Q. Do you believe capital asset pricing model theory, sometimes
19 referred to as the CAPM theory, is useful in estimating the
20 cost of common stock equity for Iowa-Illinois?
- 21 A. No. I do not.
- 22 Q. Please explain your answer?

1 if earned, Iowa-Illinois would be able to achieve a
2 satisfactory level of financial integrity.

3 Q. If one used 13.8% instead of 13.0% as the cost of risk-free
4 capital, a beta of .65 instead of .60, a market return of
5 18.2 - 19.1% as Mr. Zepp used, and an adjustment of 5% or 10%
6 for market pressure and cost of issuance, what would CAPM
7 methodology indicate Iowa-Illinois' cost of common stock
8 equity capital be?

9 A. Before adjustment for market pressure and issuance cost,
10 Iowa-Illinois' cost of common stock equity would be 15.7 to
11 17.3%. Allowing 5% for pressure and issuance, the Company's
12 cost of common stock equity capital would be 17.6 to 18.2%,
13 and at 10% for pressure and issuance, 18.6 to 19.2%.

14 It is particularly necessary to adjust for pressure and
15 issuance cost when determining the cost of common stock
16 equity. Clearly the utility if it derives less than book
17 value for its common stock cannot deliver to investors a
18 return on capital it never got. To the extent this
19 adjustment is not made and applied to the whole of the common
20 stock equity capital the investor expectation is thwarted.

21 Q. Mr. Benore, earlier you mentioned that there were internal
22 inconsistencies in Mr. Zepp's testimony. Would you identify
23 these please?

DOCKET NO. 92-0292
92-0357
Consol.

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Iowa-Illinois Gas and Electric Company	:	
	:	
Petition for an order pursuant to Section 9-213 of the Illinois Public Utilities Act.	:	92-0292
	:	
Iowa-Illinois Gas and Electric Company	:	Consol.
	:	
Proposed general increase in electric and natural gas rates.	:	92-0357
	:	

ORDER

92-0292
92-0357
Consol.

2. Staff's Position

Mr. Rungren testified that the Company is entitled to a flotation cost adjustment as compensation for previously incurred but unrecovered flotation costs. Based on his review of the Company's previous rate orders and IIGE Exhibit CAB-1, Sch. 18, p. 6, which summarizes the Company's issuance costs from 1972 through 1992, Mr. Rungren determined that the Company currently has \$835,200 of common equity flotation costs that have not been previously recovered from Illinois ratepayers (Staff Ex. 7.1, p. 9). Mr. Rungren noted that all of these costs were incurred in 1992, well after its last rate order.

Mr. Rungren calculated his flotation cost adjustment in the following manner. The total dollar amount of the Illinois portion of unrecovered common equity flotation costs was multiplied by the investor-required rate of return on common equity. That product was then divided by the equity portion of rate base, which was calculated by multiplying the common equity ratio by the rate base value. This produced the actual increment arising from unrecovered flotation costs. This increment was added to both the low and high ends of his electric and gas distribution utility cost of equity ranges (Staff Ex. 7.1, pp. 10-11). Mr. Rungren's flotation cost adjustment was seven basis points to the low ends of both the electric and gas cost of equity ranges, and eight basis points to the high ends of both the electric and gas cost of equity ranges (Staff Ex. 7.1, p. 11). After adjusting for flotation costs, his recommended costs of common equity fell within the ranges of 10.97% to 11.78% for IIGE's electric operation and 11.37% to 12.18% for IIGE's gas operation (Staff Ex. 7.1, p. 12).

Staff asserts that one of the principal advantages of Mr. Rungren's flotation cost methodology is that it does not amortize flotation costs over an arbitrary time period. Staff notes that the determination of the appropriate time period over which to amortize these costs is purely a matter of judgment. Staff indicates that Mr. Rungren's method treats common equity flotation costs in a manner similar to that used for preferred stock issuance costs; they are treated as a permanent difference between the capital contributed by investors and the proceeds received by the Company (Initial brief, pp. 78-79). Mr. Rungren testified that treating flotation costs as an operating expense would violate the principle of matching costs to benefits and, thus, would be unfair to current ratepayers. He noted that amortizing or expensing flotation costs associated with common equity, which has a perpetual life, would result in current

92-0292

92-0357

Consol.

ratepayers paying the entire costs of issuance, while the benefits resulting from common equity flow to all current and future generations of ratepayers (Staff Ex. 7.0, p. 68).

Staff notes that Mr. Rungren's methodology will compensate IIGZ for unrecovered flotation costs without reducing the unrecovered balance since it results in IIGZ receiving a "return on" unrecovered flotation costs, not a "recovery of" these costs. Staff asserts that the key point regarding Mr. Rungren's methodology is that it determines the necessary increment that must be added to the market-required return on equity to compensate common equity investors for the portion of their investment that was used by the utility to pay flotation costs. Thus, Staff concludes that Mr. Rungren's methodology will allow the utility's common equity investors the opportunity to earn their required return on their entire investment. Further, Staff notes that the consistent application of Mr. Rungren's methodology will allow all investors the opportunity to earn their required return on equity over time. Staff indicates, however, that if the amortization method is used, investors will have the opportunity to earn a return greater than their required return in the short run and less than their required return in the long run.

Mr. Rungren criticized the methodology used by Mr. Benore to calculate his flotation cost adjustment. He noted that Mr. Benore's methodology derives the common equity issuance cost adjustment by reducing the stock price by the percentage of issuance costs to gross proceeds. Mr. Rungren indicated that the rates which compensate the Company for common equity issuance costs are based, in part, on rate base, and not on the market value of common equity. He emphasized that the flotation cost adjustment should be calculated on the basis of rate base to ensure a fair opportunity for compensation. He also asserted that Mr. Benore's adjustment is not based on the Company's actual balance of unrecovered flotation costs.

Mr. Rungren also criticized Mr. Benore's adjustment for not reflecting an Illinois jurisdictional allocation (Staff Ex. 7.0, p. 66). In response, the Company states that the capital structure used to set rates is a total-company capital structure, not a jurisdictionally allocated one. The Company contends that it makes no sense to allocate one portion of the capital structure (e.g., issuance costs), but none of the other portions. The Company also asserts that the concept of jurisdictional allocation contemplates that issuance costs be treated as an expense item. The Company notes that it and Staff agree that